Office of Chief Counsel
Internal Revenue Service

memorandum

CC:FIP:B04:PRENO-136486-06
JEGlover

date:

to: Manager, EO Technical Group 3 T:EO:RA:T:3
Robert C. Harper, Jr.

from: Donald J. Drees, Jr.
Acting Chief
CC:FIP:B04

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subject: **Request for Technical Assistance**
Taxpayer: [redacted]

We previously provided technical assistance which you considered in reaching a tentative conclusion adverse to Taxpayer's application for recognition of exemption under § 501 of the Internal Revenue Code. We also participated in the conference of right. You ask that we evaluate our prior assistance in light of the additional material and argument submitted by Taxpayer subsequent to the conference of right.

In our prior assistance, we agreed with your conclusion that Taxpayer did not qualify as an insurance company for purposes of federal income taxation for the taxable year [redacted] is the sole owner of [redacted] ("[redacted]") and of [redacted] ("Systems"). [redacted] also has an ownership interest in [redacted] ("Services"). Apparently, all three of these entities were sub-contractors on [redacted] projects. The classification of Services under § 301.7701-3 of the Procedure and Administration Regulations is unclear[1]. [redacted] is also the sole owner of Taxpayer. Taxpayer's only activity is a contract ("Contract") by which it agrees to "pay those sums that [covered parties] become[] legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this [contract] applies" which Contract indicates is that "caused by an 'occurrence' that takes place in the 'covered territory.'" Contract defines "bodily injury" to be "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time." "Property damage" is defined as the physical injury and loss of use of the property. An

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1 Apparently more than one individual has an ownership interest in Services, suggesting it has more than one owner hence is not susceptible of being a disregarded entity. However, it is our understanding that Taxpayer represents that under ownership attribution rules Services would be viewed as having only one owner, if Services is viewed as having only one owner, it is disregarded unless it is classified as a corporation. Without an absolute representation on this point from Taxpayer, resolution of Services' classification must come from CC:PSI.

"occurrence" is "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." And the "covered territory" means the United States and possessions, Puerto Rico, Canada, and international water and airspace in transit between such places. Contract indicates that it provides claims-made commercial general liability coverage.

Contract states that it covers those entities designated in its declarations page and, in essence, their agents. Contract's declarations names [redacted] Systems, and Services as "named insureds". Attached to Contract is an endorsement for "additional insured – owners, lessees or contractors – automatic status when required in construction agreement with you" which serves to amend the description of who is covered by Contract "to include ... any person or organization for whom you are performing operations ... with respect to liability arising out of your ongoing operations performed for that [person or organization]. A person's or organization's status as [covered by Contract] ends when your operations for that [person or organization] are completed."

Our initial assistance focused on the structure of Contract, which we concluded was best analogized to that described in Rev. Rul. 2002-90. For purposes of our initial assistance, we presumed Services to be an entity regarded separately from its owner.[2] Because it appeared that Contract covered only three entities: [redacted] Systems, and Services, with [redacted] accounting for [redacted]% and Services [redacted]% of Taxpayer's coverage, we concluded that risk distribution was not effected hence Contract did not constitute insurance.[3] See also Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (allocation of risks 90% to one entity and 10% to another does not achieve risk distribution). Because Contract was Taxpayer's only activity, Taxpayer did not qualify as an insurance company.

Taxpayer now points out that in addition to [redacted] Systems, and Services, [redacted] unrelated entities that were the general contractors for whom [redacted] worked were additional insureds under Contract. These additional insureds were identified in a "certificate of liability insurance" issued in their name on behalf of Taxpayer through [redacted] It is not clear if the subcontract between the [redacted] general contractors and [redacted] required the subcontractor to provide insurance coverage for the general contractors. Nonetheless, the copies of the certificates of liability insurance made out in the name of each covered general contractor suggest the coverage was not etheric. Taxpayer argues that applying the analysis of Crawford

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2 However, if the correct technical conclusion is that Services should be disregarded as an entity separate from [redacted] our initial conclusion that Taxpayer was not issuing insurance contracts during 2003 would be strengthened; treating Services as disregarded would reduce the distribution of the risk because of the resulting fewer covered entities.

3 There was some indication in the initial submission that Contract was to cover "construction defects". However, it is not clear that Contract provides such coverage. F&H Const v. ITT Hartford Ins. Co. of Midwest, 118 Cal. App 4th 364 (3d Dist. 2004) Were to provide such coverage, it is not certain that such coverage would involve an insurance risk. (See e.g., G C.M. 39146.)

Fitting Co. v. United States, 606 F. Supp. 136 (N. D. Ohio 1985), these 'additional insureds' should be included in evaluating risk distribution; the combined [redacted] insureds being sufficient to effect risk distribution.

For [redacted] Taxpayer received premium for Contract of $[redacted] of which $[redacted] ([redacted]%) was from [redacted] $[redacted] [redacted]%) was from Systems, and $[redacted] ([redacted]%) was from Services. Taxpayer represents that the consideration paid by the "additional insureds" was factored into the consideration for the subcontract and subsumed into that paid by [redacted]; the amount allocable to the additional insureds accounted for 70-80% of the amount paid by [redacted]

As Taxpayer observes, the Ninth Circuit Court of Appeals (to which an appeal of this case apparently would lie) observed that

> discussions of ['what is insurance'] might seem less abstruse if we asked ourselves a somewhat different question: "suppose we ask not 'what is insurance?' but 'is there adequate reason to recharacterize the transaction?,' given the norm that tax law respects both the form of the transaction and the form of the corporate structure...For whether a transaction possesses substance independent of tax consequences is an issue of fact...

AMERCO, Inc. v. Commissioner, 979 F.2d 162, 168 (9th Cir. 1992)(quoting Sears Roebuck & Co. v. Commissioner, 972 F.2d 858, 864 (7th Cir. 1992). Nonetheless, the Ninth Circuit also recognized that "[a]s precedent requires, we have discussed this case from the standpoint of risk-shifting and risk-distributing." AMERCO, at 168. Accordingly, we apply the criteria of risk shifting and risk distribution in evaluating whether an arrangement constitutes insurance for federal income tax purposes. See Rev. Rul. 2005-40; Rev. Rul. 2002-90, 2002-2 C.B. 985.

The concept behind the element of risk distribution required for an arrangement to constitute insurance is that when premiums from multiple "insureds" are pooled, no potential insured in significant part pays for its own risks. This enables the statistical phenomenon known as the 'law of large numbers' to operate allowing the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premium and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. Rev. Rul. 2005-40.

Crawford Fitting Co. involved a "captive insurance arrangement" between related companies engaged in manufacturing valve and valve fittings and a related "insurance" company. Among the entities covered by the captive were "115 independent distributors, none of which are owned directly or indirectly by [the operating

companies]". Id., at 138. The opinion describes the distributors as being among the insureds named in the contract: "[t]he named insureds under the policy included ... the other manufacturing companies, the numerous companies that supply goods and services to the manufacturing companies, the 115 independent distributors ..., the profit sharing trusts ..., as well as [four individuals]." Id., at 147. "[T]he amount of premiums relating to the potential liability of the independent distributors was incorporated in the premium paid by [one of the operating companies]", Id., and the court found risk distribution because "[t]hese various persons and entities covered under the policy existed independent of the plaintiff, and the risks they faced were sufficiently similar and independent of those faced by the plaintiff so as to make the sum of the risks carried by the captive company less than the sum of risks of the insureds." Id.

It appears that most of the performance required under Contract would occur in California; [redacted] Systems, and Services are located in California, the covered general contractors are located in California, and the work projects to which the coverage of Contract pertained are located in California. Therefore, California law would govern the interpretation of Contract. 12 Cal. Jur. 3d *Conflicts of Laws*, § 97 (2006)("...a California rule of conflict of laws to the effect that an insurance contract should be interpreted according to the law of the state in which the most performance takes place.")

California law interprets the scope of coverage provided by commercial general liability policy according to the policy's terms. For example, in St. Paul Fire and Marine Ins. Co. v. Am. Dynasty Surplus Lines Ins. Co., 101 Cal.App.4th 1038 (2002),

> the subcontractor promised to add the general contractor to its liability policy as an "additional insured," but such coverage would only extend to "liability arising out of" the subcontractor's ongoing operations for the general contractor.

Id., at 1042. The endorsement adding the general contractor "provided coverage to [the general contractor] only with respect to *liability* arising out of [subcontractor's] ongoing operations." Id. at 1043 (emphasis original). One of the subcontractor's employees was injured on the jobsite; "such injury resulted entirely from activities of [the general contractor] that were *unrelated* to the work called for in the subcontract". Id. at 1042 (emphasis original). Observing that "to resolve any ambiguity in the meaning of the additional insured endorsement, it would appear to be necessary to read its provisions together with and in the context of, the [subcontract]", Id. at 1056, the court concluded that the policy "must be interpreted as providing coverage to [the general contractor] only for *liability* arising, at least in part, from [subcontractor's] activities in its performance of the subcontract. In other words, an 'act or omission' by [subcontractor.]" Id. at 1060 (emphasis original). This is consistent with the general purpose of such endorsements, which "are intended to protect parties who are not

named insureds from exposure to *vicarious* liability for acts of the named insured." Id. (emphasis original)(citation omitted). Accordingly, the endorsement did not cover the general contractor.

In Acceptance Ins. Co. v. Syufy Enter., 69 Cal.App.4th 321 (1999), the court considered an additional insured endorsement to a policy issued to a contractor that covered the owner of the jobsite. The endorsement provided that the owner "was included as an additional insured under the policy, 'but only with respect to liability arising out of [the contractor's] work' for that insured by or for [the contractor]"; the covered work was "[w]ork or operations performed by [the contractor] or on [the contractor's] behalf". Id., at 324. One of the contractor's employees was injured due to negligent building maintenance by the owner; the owner claimed coverage under the endorsement. Construing the policy against the insurer and in favor of coverage, the court found for the owner; "[t]he fact that the defect was attributable to [the owner's] negligence is irrelevant, since the policy language does not purport to allocate coverage according to fault." Id., at 328-29. The court explained

> [i]nsurance companies are free to, and commonly have, issued additional insured endorsements that specifically limit coverage to situations in which the additional insured is faced with vicarious liability for negligent conduct by the named insured ... when an insurer chooses not to use such clearly limited language in an additional insured clause, but instead grants coverage for liability 'arising out of' the named insured's work, the additional insured is covered without regard to whether the injury was caused by the named insured or the additional insured.

Id., at 330.

Black's Law Dictionary defines "vicarious liability" as "[i]ndirect legal responsibility; for example, the liability of an employer for the acts of an employee, or, a principal for torts and contracts of an agent." Black's Law Dictionary, 5th ed. 1404 (1979). In other words, vicarious liability is founded on underlying liability of another; it is not liability founded on one's independent acts.

In Vitton Constr. Co. v. Pacific Ins. Co., 110 Cal.App.4th 762 (2003), a contract between a general and a sub contractor required the subcontractor to name the general contractor as an additional insured on its liability insurance policy. The policy contained a "Blanket Additional Insured endorsement" that covered the additional insured "with respect to liability arising out of ... "[subcontractor's] work" for the additional insured or for you", in other words, "with respect to 'liability arising out of' [subcontractor's] work". Id. at 764. An employee of another subcontractor was injured at the site where subcontractor had completed its work due to the general contractor's negligence in

maintaining site's safety. The court observed that "the fact that an accident is not attributable to the named insured's negligence is *irrelevant* when the additional insured endorsement does not purport to allocate or restrict coverage according to fault." Id. at 767-68 (emphasis original). The court contrasted the language of the Vitton endorsement with that in St. Paul: "unlike the endorsement in St. Paul, the additional insured endorsement here did not limit coverage to liability arising out of the subcontractor's 'ongoing operations performed for' the general contractor", Id., at 769, and the general contractor was covered for its own independent negligence by the additional insured endorsement.

In summary, it appears that under California law an "additional insured" will be covered for its own liability, independent of that of the "named insured", if the additional insured endorsement is broad enough to reflect the parties' intent for such coverage. If the additional insured endorsement is narrow, reflecting the parties did not intend such coverage, then the additional insured will only be covered for its vicarious liability from acts of the named insured.

Here, Taxpayer's additional insured endorsement provides as follows (emphasis added):

This endorsement reflects the intent to provide coverage for additional insured. But this endorsement is more akin to the "narrow" endorsement in St. Paul than the "broad" endorsement in either Syufy or Vitton. Taxpayer's endorsement appears to limit coverage for the additional insureds to those situations in which they are found vicariously liable for the acts or omissions of [redacted] As such, the additional insureds do not present risks sufficiently independent of those faced by [redacted] so as to make the sum of the risks carried by the Taxpayer less than the sum of risks of the insureds. Crawford Fitting, at 147.

Accordingly, we reiterate the conclusion of our previous technical assistance.

If you have any questions or wish to discuss this further, please contact John Glover at (202) 622